To: Jim Winkler, COP, and Tocher Mitchell, Director of Finance, ESP Project
From: Mary Miller, Banking Specialist, DAI
Date: 2 August 2005
Re: Second Interim Report, Institutional Upgrade of HAMAG – Technical Assistance with Assumption of the UNDP/EU Guarantee Fund

Background and Progress

This visit was a part of a series of visits to assist HAMAG in expanding its guarantees. The areas of assistance, and thumbnail sketches of progress, are summarized below:

1. Upgrading HAMAG's administrative capacity with respect Agreement between HAMAG and UNDP/UNOPS – the agreement for the transfer of the funds was finally concluded in June. As a part of this visit calls were made on two of the four UNDP banks. Results are summarized in the Annex 2 memo to HAMAG concerning followup to these calls.

2. Assisting HAMAG to further develop its database and MIS so that it can accommodate the additional guaranteed loans from the UNDP/EU funds and increased organic growth – No additional work was done in this area on this visit. HAMAG's new system does have a few bugs that it is working out. See comments in the Annex 1 memo concerning electronic reporting from the banks on status of outstanding guaranteed loans.

3. Helping develop an efficient mechanism to conduct annual reviews of HAMAG's entire guarantee portfolio – necessary loan status information is starting to be collected.

4. Assessing and making suggestions for improving HAMAG's guarantee origination and approval process – ongoing, and summarized in the Annex 1 memo .

5. Assessing the feasibility of developing for HAMAG and the Croatian commercial banks a program similar to the U.S. Small Business Administration Certified or Preferred Lender Programs – to date the agency has been quite reluctant to consider instituting a preferred lender program. See discussion in the Annex 1 memo.

6. Training a HAMAG Croatian counterpart, who will assume responsibility for overseeing the UNDP/EU Guarantee Fund portfolio – Katerina Kuhanec, the new HAMAG finance officer for these guarantee funds, was the lead on the bank meetings. See comments in the Annex 2 memo.

Current Activity

HAMAG has a new Executive Board President, Tomislav Kovacevic, who clearly is charged with greatly increasing the volume of guarantees issued by HAMAG. Accordingly he seems more receptive to making changes in the program, and taking more of an activist approach to HAMAG's role in facilitating SME credit.

Changes are starting to take place. The new programs are being used more actively than the old programs, HAMAG has taken over the UNDP guarantees, and it has sent out requests to get updates on outstanding guaranteed loans. At the staff level there seems to be a great suspicion of anything associated with the commercial banks, and this attitude will have to be altered for the agency to be effective.

While HAMAG has been reluctant to create a preferred lender program for the banks that have been submitting guarantee requests, they feel that they are obligated to do this to get participation from Privredna Banka and Zagrebacka Banka (and politically feel obliged to do so). A major question that has surfaced is whether HAMAG should issue unconditional guarantees, by which they apparently mean that not even the use of loan proceeds should be confirmed. The study tour planned for September may provide some useful guidance on this point.

Summaries of activities are contained in two memos, as follows:

Annex 1 – Memo to Kovacevic, summarizing overall progress in working with HAMAG. This should be sent on to Kovacevic by Tocher Mitchell on behalf of ESP.
Annex 2 – Memo to HAMAG summarizing the UNDP bank visit, and recommending next steps. This has already been provided to Katarina Kuhanec, with instructions that it should be passed on to Kovacevic and others at HAMAG.

Note: It would be useful for the memos written to Zoran Barisic in May, 2005 to be provided again to Kovacevic, who may not have seen them. These summarized the need to collect loan status information from the banks, described how a preferred lender program could work, and made suggestions on how to work actively with the UNDP banks.

Planned Study Tour

A study tour is planned for early September 2005 to meet with the national US Small Business Administration, as well as the Richmond and Washington offices, and other banks and business centers. This visit is expected to be a significant catalyst in encouraging a preferred lender program. The action planning session at the end of this tour is expected to set the tone and agenda for the balance of ESP assistance to HAMAG in increasing its assistance to SMEs through greater issuance of guarantees.

ANNEX 1

To: Tomislav Kovacevic, Executive Board President, HAMAG
From: Mary Miller, Banking Specialist, Development Alternatives, Inc., for ESP
Date: 27 July 2005
Re: Cooperation of HAMAG and ESP
CC: Tocher Mitchell, Director of Finance, ESP Project

Background Summary

HAMAG and ESP have the common goal of trying to increase the amount of credit available to SMEs. We both recognize that growing businesses create jobs, and economic growth in the country, and that business growth is limited if credit is not available.

Our cooperation has been focused on two projects:

- Development of a preferred lender program, so that HAMAG can greatly increase the volume of guarantees that it issues and thereby have a greater benefit for SMEs
- Assumption by HAMAG of the UNDP-EU Guarantee Funds to encourage lending in the areas of special state concern

HAMAG historically has issued over 3,000 guarantees, but most of these were issued several years ago, and the program was totally inactive for some time. Since re-activation about two years ago, the program has issued some guarantees, including 25 or so since the beginning of this year. The program is more active now, because HAMAG has changed its guarantee policies and programs to be more in line with guarantees requested by the bankers. We think that the new guarantee products are good, and should help increase the number of loans issued for SMEs.

In our opinion, the greatest problem that HAMAG faces is one of attitude – HAMAG historically has had a bad relationship with the banks. Regardless of the reasons or fault for this (and fault seems to be on both sides) this attitude has to be changed. HAMAG and the banks have the same goal – to increase the amount of loans going to SMEs – so their interests are in common, not opposed to each other.

Creation of a Preferred Lender Program

HAMAG will only be effective if it can facilitate a great number of loans being issued by commercial banks. ESP has spent considerable time with HAMAG staff to discuss the creation of a <u>preferred lender program</u>, whereby a bank that frequently requests guarantees, and maintains its loan portfolio well, is officially or unofficially given a broader authority to designate loans for guarantees. The guarantee approval process can then be streamlined so that it is more of a review process than actual analysis.

In discussions with Mr. Zdravko Muraj, the head of the Guarantee Department, it appears that the reason for most of the declines of guarantees by HAMAG are attributable to "formal reasons", i.e., the request does not meet HAMAG program requirements. At the same time, Mr. Muraj indicated that HAMAG will still do a thorough analysis of the request, as a service to the entrepreneur. In our view this approach is not productive. HAMAG's relationship is with the bank, not directly with the entrepreneur. It appears that some of the banks, or branches, are not reviewing requests prior to sending them to HAMAG, or are using HAMAG's decline as an excuse to avoid declining the loan themselves. In either case this is a waste of time, and is unacceptable . If requests are not sufficiently documented, or clearly do not qualify for a guarantee because the underlying loan is too poor, these should be quickly returned to the bank without analysis.

It may be helpful to consider that HAMAG, in any case, should not be doing the bank's job. If the bank does a poor job of analyzing a loan request, HAMAG should not do the analysis for them – it should insist that the analysis be properly done. On the other hand, if the bank's analysis is good, HAMAG should not repeat the same process. The latter is the basis for instituting a preferred lender program.

In preparation for instituting a preferred lender program HAMAG should start conducting one-on-one meetings with the banks to establish a working relationship and agree on an analysis procedure so that approvals can be done more quickly. HAMAG has already done this with HBOR, and as a result about half of the new guarantees issued have been for HBOR.

We also recommend that individual analysts be designated as relationship managers for the participating banks. This gives the bank a single, responsive point of contact at HAMAG and someone with whom they can establish a working relationship. From HAMAG's point of view, the relationship manager can be given responsibility for marketing the program to individual banks. (This would also be an appropriate basis for establishing performance targets for personnel review.)

Communication

This past spring HAMAG made formal presentations of its new guarantee programs to the banks. It is planning to make more such presentations this fall, as it is clear that not all the program requirements are understood. We believe that the formal presentations are important and useful. However, formal presentations are not the only way to communicate with the banks, and we strongly encourage that different methods should be used as well. These include regularly sending mailings of information, as well as e-mails, phone calls, and other informal methods of communication. A relationship manager is best positioned to conduct this type of informal and frequent contact.

It is important to remember that frequent communication at all levels is the best way to actively "sell" the guarantee program to the banks. More guarantees will be issued if HAMAG is encouraging the use of the program rather than passively waiting for guarantee requests to be submitted.

Status of Guaranteed Loans

HAMAG recently sent requests to the banks to report on the status of outstanding guaranteed loans, including loan balance and whether payments are being made currently. To date responses have been received from several banks, but it appears that none of the information provided by the banks has been used to update HAMAG's database.

It is important that HAMAG process this information, so that it can measure its risk position and be able to estimate the level of payouts that it will have to make in the future.[1] In addition to measurement of risk exposure, HAMAG can use this information as a basis for conferring preferred loan status.

In this reporting process two significant issues have emerged:

- "Lost" or undocumented guarantees, largely arising from the takeover of a loan portfolio by a successor bank, where the current bank does not know that its loans were guaranteed – all discrepancies of this type should be settled so that HAMAG and the banks are in agreement going forward as to what the guarantee coverage is
- The need for <u>electronic reporting</u> – this is the more significant issue because it will be recurring. Privredna Banka, for instance, has reported about 250 guaranteed loans outstanding, and it will be a substantial burden to do the input to record this information, and keep it up to date. In cases such as these the HAMAG information technology manager needs to meet with the IT manager of the respective banks to arrange for the information to be transferred in electronically.

Results of Meetings with UNDP Program Banks

A separate memo concerning meetings with Jadranska Banka and Nova Banka was submitted to HAMAG staff. In summary, we feel that HAMAG needs to institute and continue an activist approach in dealing with these banks, to encourage them to actively seek new SME loans for the program. Once similar meetings have been held with Pozeska Banka and Croatia Banka, we recommend that you report back on meeting results in a memo to UNDP and the European Union. While such reporting is not required, it would be useful to support ongoing constructive relations with these two agencies.

Relations with HBOR

ESP recognizes that HAMAG is obliged to cooperate with certain other Croatian government agencies such as HBOR. However, we note that providing a guarantee for

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[1] Historically HAMAG has had a 5% payout rate, and discussions with staff indicate that this rate is expected to continue in the future. However, a review of the reports being submitted by the banks indicate that the payout rates will be higher than this.

another government agency provides no additionality. HAMAG should be focusing its efforts on leveraging the commercial banks to provide more credit to SMEs. In discussion with HAMAG staff it appears that HAMAG has established a good working relationship with HBOR, which is the reason that half of the new guarantees have been issued for HBOR loans. We strongly encourage HAMAG to consider this relationship as a model for developing business with commercial banks, and de-emphasize assistance to HBOR as much as possible.

<u>**ANNEX 2**</u>

To: HAMAG
From: Mary M. Miller, Banking Specialist, DAI, for ESP Project
Date: 27 July 2005
Re: Followup on Meetings with Jadranska Banka and Nova Banka
CC: Tocher Mitchell, Director of Finance, ESP Project

Summary of Meetings

In meeting with the UNDP banks we decided to take a very pro-active approach, as we wanted immediately to set the tone of the working relationship that we expected the banks to be actively using the guarantee program. The initial meetings with Jadranska Banka and Nova Banka followed an agenda which covered the following points:

1. Transfer of guarantee from UNDP/ILO to HAMAG – a letter from HAMAG acknowledging this was provided, and a copy is to be countersigned and returned.
2. Banks will provide documents and signature cards for transfer of deposit funds. (Note: agreement calls for dollar deposits to be converted to Euros.)

Basis for Protocol Agreement:

3. Development of a working procedure for approving new loans under the agreement – banks will use a modified HAMAG cover application, as well as a checklist of requirements from the agreement (provided electronically). In general it is expected that the banks will use their existing analysis procedures for reviewing loans. LEDAs, or other business assistance agencies, are expected to be involved as referral sources, but will not provide business plans or be involved in the loan approval procedure.
4. Collection procedure for problem loans – banks are following their usual procedures for collecting loans. Specific information was provided at the meetings on several of the SME loans, and will be provided (by August 15) on the personal loans.
5. Requests for payment of guarantees – Banks will provide documented requests for guarantee activation initially by August 15.
6. Monitoring procedure – Banks will continue to provide monthly lists of loans and status, as well as reports on actions being taken to collect problem loans. In comparing the lists of loans provided by Nova Banka as of 31 March and 31 May respectively it became clear that some of the problem loans had dropped off the list. This will be researched and a more accurate list sent.
7. Targets for future loans – Banks will provide projections of new loan activity for the coming six months by 15 August. The specific point was made that if a bank was not active in the program that funds could be transferred to another bank that was interested in being active in lending to SMEs in the target counties.

Specific Discussion Items

<u>Eligible counties</u> – the agreement indicates that SMEs and other certain borrowers whose business is located in these counties are eligible for loans. The agreement does not

specify that the businesses need to be located in the areas of special state concern. However, the agreement does indicate that they should contribute to economic growth and job creation in those counties.

Interest rate - Per Annex III, No. 4, the interest rate should be the "lowest possible market interest rate", not to exceed 6.5% in the first year of the program. My interpretation of this requirement is that the rate should be a "market" rate, i.e., should not be a concessionary rate (this would be in keeping with UNDP's concept that the credit culture should be maintained). On the other hand, as half of the loan funding is being provided by the guarantee deposit account, the rate should be better than a comparable loan without such associated deposits.

Revaluation or Devaluation of Currency – Also in Annex III, No. 4, is a requirement that the loan balance be adjusted depending on the exchange rate of the Kuna relative to the Euro, and the method of adjustment is not in keeping with the banks' loan accounting systems. Several of the banks did point this out to UNDP when the agreement draft was circulating, but no change was made. In my view this requirement can and should be changed, as making the change means that the banks will be more willing to participate in the loan program. I have drafted a letter for Mr. Kovacevic to send to all the banks on this point, which you may use or alter as you choose. This draft is at the end of this memo.

Does the Guarantee Cover Interest and Principal, or just Principal – Per our review of the prior agreements, it is clear that loans granted under these prior agreements include the guarantee of interest as well as principal. For the new loans going forward, however, I think that this is not necessary. In Annex III, No. 3, for instance, an example is shown of a 70% guarantee of a loan of Euros 70.000, and indicates that the maximum possible value of a guarantee cannot exceed € 49.000, which suggests that the guarantee only covers principal.

In the event that banks insist on interest being covered as a condition of participating in the new program, I suggest that you negotiate to cover no more than three months' worth of interest. It is your concern that the banks be active in collecting past due loans, and allowing unlimited coverage of interest defeats this purpose.

Even if you do choose to cover all or some interest, you do have the benefit of the ceiling set in the agreement, per the example above. The agreement clearly indicates that the maximum payout should be 50% or 70% of the original loan amount, which is not to exceed € 70,000. In other words, interest could only be covered if there have already been payments of principal before the guarantee is activated.

Next Steps

1. A good momentum has been established with Jadranska Banka and Nova Banka. The immediate followup should be to send a letter to each bank summarizing the documents to be returned to HAMAG, and the dates that additional information and reports are expected. Continued contact through e-mail, phone calls, and

letters, reminding the banks of deadlines, thanking them for information, asking about progress, are all important to continue to build relationships.

2. Additionally, similar meetings (guided by the same agenda) should be held with Pozeska Banka and Croatia Banka. These meetings should be held as soon as is feasible.

3. One subject that was not addressed at the meetings is the question of expired guarantees – i.e., for those loans that have been fully repaid, and the guarantee cancelled. The last paragraph of Annex III, No. 6 indicates that the bank should return the guarantee document within 180 days of the full payment of the loan or realization of the guarantee, so that the guarantee can be cancelled. I suggest that you discuss this matter with the banks after you receive the next listing of loans, asking them to confirm that the guarantee is no longer needed for certain specified loans. It would be appropriate for them to send back to you the guarantee letter that they received from UNDP. Thereafter those loans could be dropped from the reporting schedule.

4. Finally, HAMAG's guarantees should be incorporated into HAMAG's own guarantee accounting system, and updated as information is received. Given that these portfolios are substantial, it would be advisable for HAMAG system specialists to meet with the bank counterparts to arrange an electronic reporting.

Sample Kovacevic Letter re Revaluation or Devaluation of Currency:

Re Agreement between HAMAG, UNDP and ILO for Transfer of Ownership of Credit Guarantee Schemes under the Projects CRO/96/002, CRO/98/Q04, CRO/00/Q02, CRO/02/Q02 and CRO/02/Q03

Dear ----- (Bank President)

It has come to our attention that the second paragraph of Annex III, No. 4 of the above-referenced agreement specifies a method of adjusting loan balances depending on the revaluation or devaluation of the Kuna to the Euro that is not compatible with the bank loan accounting systems in common use in Croatia. The purpose of this guarantee program is to encourage the participating banks to make loans to SMEs and other eligible borrowers to contribute to economic growth and job creation in the target counties. In our view the method of accounting for currency revaluation or devaluation does not affect the purpose of the program, therefore we remove this requirement and encourage the banks to use their ordinary loan accounting software to track program loans.

Sincerely,

Tomislav Kovacevic, Executive Board President